

ANALYSIS OF ORIGINAL BILL

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Bill
Number: AB 80

Related Bills: AB 458 (1995/96)

Telephone: 845-3036

Introduced Date: 12/18/96

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Substandard Housing or Substandard Vacant Property/ Prohibition of Deduction

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would add substandard vacant property (defined as abandoned or unoccupied dwellings) to the definition of "substandard housing" for which related business expense deductions may be disallowed.

EFFECTIVE DATE

As a tax levy, this bill would become effective when signed and would apply to taxable years beginning on or after January 1, 1997.

PROGRAM HISTORY

In 1974, the Legislature passed Assembly Bill 475 (Ch. 238), enacting the Substandard Housing Audit program (SSH). This law requires the Franchise Tax Board (FTB) to disallow interest, depreciation, tax and amortization deductions to a taxpayer deriving rental income from substandard rental property. The funds generated by the denial of a deduction are returned to the local government. This program is intended to:

- penalize landlords who fail to comply with codes and
- provide landlords with an immediate incentive to bring substandard properties into compliance.

In recent years, the department has identified several issues which have prevented the SSH program from being effective including:

- no social security number is provided with the notices of noncompliance, resulting in an inability to perform adjustments to the taxpayer's account where the department is unable to locate the taxpayer (approximately 60% of cases);

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Department Director Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___X___ NA ___ NAR
___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

4/4/97

Agency Secretary

Date

By:

Date:

- some owners of substandard housing do not earn enough income to require that they file a tax return. Thus, no adjustments can be made since SSH deductions were never reported;
- some property owners of SSH properties have suspended passive activity losses, preventing them from taking deductions on SSH properties and limiting the effectiveness of disallowing deductions to taxpayers (according to department staff, this represents approximately 13% of cases); and
- the value to owners of SSH of lost deductions is often less than the cost to rehabilitate the properties.

Overall, in the cases the department is able to identify, approximately 79% of the owners are not assessed additional taxes because of passive activity losses (PALs), nonfiling or insufficient income. Thus, most taxpayers referred to the department never actually pay a monetary penalty. Local agency participation in the program has dropped, apparently as a result of the lack of revenues generated by the program.

SPECIFIC FINDINGS

Current law mandates that the FTB administer a Substandard Housing Audit Program. The program is intended to assist local authorities in abating housing violations that result in dangerous and unhealthy living conditions. The law applies to taxpayers who derive rental income from substandard housing in this state, including employee housing.

Under the current law, when the State of California or a local regulatory agency declares California rental real estate in violation of health, safety or building codes and the substandard rental housing has not been brought up to standard within six months or declares employee housing in violation of the Employee Housing Act and the housing has not been brought up to standard within 30 days, a notice of noncompliance may be issued to the owner by the regulatory authority. A copy of the notice is also sent to the FTB. The notice of noncompliance includes an explanation of the tax consequences for an owner deriving income from substandard housing and is recorded with the appropriate county recorder. The regulatory agency charges the substandard housing owner a fee to recover the cost of recording and releasing the notice of noncompliance.

Upon receipt of a notice of noncompliance, the FTB must identify the taxpayer. The FTB then audits the corporate, partnership, fiduciary or individual income tax return and disallows any deductions for interest, taxes, depreciation, or amortization that are claimed on the substandard rental property for the period of noncompliance. If the period of noncompliance is less than a year, the expenses are disallowed on a prorated basis.

Tax revenue collected through the program is tracked by the department and distributed by the State Controller to the local authority that initiated the action.

Existing federal and state law provide that, for any taxpayer who is an individual, estate, trust, closely held C corporation, or personal service corporation, passive losses and credits may only be used to offset passive income (income derived from passive activities). Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Prior to the enactment of the federal Revenue

Reconciliation Act of 1993, rental activities, including rental real estate activities, were treated as passive activities, regardless of the level of taxpayer participation. A special rule permitted the deduction of up to \$25,000 of losses from rental real estate activities (even though they were considered passive) if the taxpayer actively participated. This \$25,000 amount was allowed for taxpayers with adjusted gross income of \$100,000 or less and was phased out for taxpayers with adjusted gross income between \$100,000 and \$150,000.

The federal Revenue Reconciliation Act of 1993 provides that rental real estate activities in which the taxpayer materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services.

Existing state law did not conform to the 1993 federal Revenue Reconciliation Act and, therefore, still provides a deduction of up to \$25,000 of losses from rental real estate activities.

AB 80 would broaden the scope of the substandard housing audit program by providing that, along with taxpayers who derive rental income from substandard housing, the law would apply to taxpayers who own substandard vacant property. The bill would define vacant property as any abandoned or unoccupied dwelling.

This bill would specify that the disallowance relating to substandard vacant property does not apply to any lender engaging in a "federally related transaction," as defined in Section 11302 of the Business and Professions Code, who acquires title through foreclosure or a deed in lieu of foreclosure.

Policy Considerations

Many taxpayers who receive substandard housing notices of noncompliance may own multiple rental properties. Consequently, their rental real estate losses may exceed the \$25,000 regular tax offset. Disallowing the deductions for interest, taxes, depreciation, or amortization may result in a reduction in the suspended loss rather than a current year tax increase.

The annual amount assessed under the SSH program has declined in recent years due to decreased participation by local agencies. This bill would expand the scope of the SSH program without correcting the problem areas of the program. Thus, it is unclear whether this bill would provide a significant deterrent to owners of substandard vacant property.

Because of the issues discussed under Program History, this program has not operated as effectively as intended. Moreover, substantial changes to tax law would be required to make this program effective. If this bill's intent is to force SSH landlords and owners of vacant properties to comply with building, safety and health codes, a program providing penalties for SSH landlords, imposed directly by the impacted local jurisdictions, may be more successful in compelling compliance by owners of SSH buildings.

Implementation Consideration

It is unclear whether the author intends to disallow deductions to substandard vacant land or commercial buildings as well as vacant dwellings. A clear definition for the type of property to be disallowed deductions will be needed to implement the bill. Department staff is

available to assist the author's office with language to resolve this concern.

While this bill may increase the number of substandard audits conducted by the department, the increased workload is not expected to be significant. Implementation of this bill would require some changes to existing tax forms, instructions and audit manuals, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue collected through the SSH program is transferred semiannually to local regulatory authorities and would have no revenue impact on the General Fund.

Any state tax revenue effects that may occur as a result of taxpayers' correcting code violations (which would produce additional business expense deductions) due to this act are conjectural, but would probably be insignificant in any given year.

Any possible changes in employment, personal income, or gross state product that might result from this provision are not taken into account.

This estimate does not address possible savings to the General Fund that might result from a reduced need for local authorities budget appropriations for local agencies.

According to departmental data, collection for the SSH program for the period between July 1, 1995, and June 30, 1996, totaled less than \$120,000. This amount was distributed by the State Controller to local authorities in Alameda, Fresno, Los Angeles, and San Francisco counties.

POSITION

Neutral, if amended.

The staff's position will be neutral if the implementation concern regarding the definition of substandard vacant property is resolved.